January 2009

# U.S. Quarterly

# Market Perspective

## Executive Summary


- The commercial real estate market has followed the larger economy into a downturn that is likely to last through 2009 and possibly into 2010. With unemployment rising, consumer spending falling and home prices dropping, the recession will impact all sectors of the real estate market.
- It is not yet clear when commercial mortgage debt will be readily available. The CMBS market is out of the picture and traditional lending sources are trying to preserve capital. The lack of reasonably priced debt has made it difficult to complete transactions.
- Tarred with their association with financial firms and use of mortgage debt, shares of U.S. REITs fell amid unprecedented volatility in 2008. The sector should gain in 2009, but remains subject to the performance of the economy and the debt capital markets.
- After falling to historical lows of roughly 5.4% in 2008, cap rates are likely to return to levels more in line with the 7.8% National Council of Real Estate Fiduciaries (NCREIF) historical average. Combined with declining net operating income, property values will drop sharply from their peaks.
- With distress comes potential for opportunities. The disconnect between the pricing of public and private real estate, and equity and debt, creates inefficiencies that can be exploited by investors with available capital.


## Overview

The start of a new year often brings fresh hope, but as 2009 commences, optimism is in short supply in the commercial real estate market. The sector suffered through its worst returns in decades in the fourth quarter, and property values are expected to decline again this year. The swiftness of the decline was stunning, even in an environment in which bad news was expected. Deteriorating economic conditions are likely to get worse before they get better and thus continue to undermine real estate fundamentals, prolonging the time when we begin to see a recovery. Deleveraging is working its way through the system as the market adjusts from a high-leverage system to one in which debt is scarce. Taken in combination, these conditions will make 2009 a very challenging year, but one in which an overdue cleansing of the system is likely to commence in earnest. Glimmers of hope come from the fact that interest rates and energy prices are low, good for both the consumer and business, and the new administration's giant stimulus package could boost economic activity by the second half of the year.


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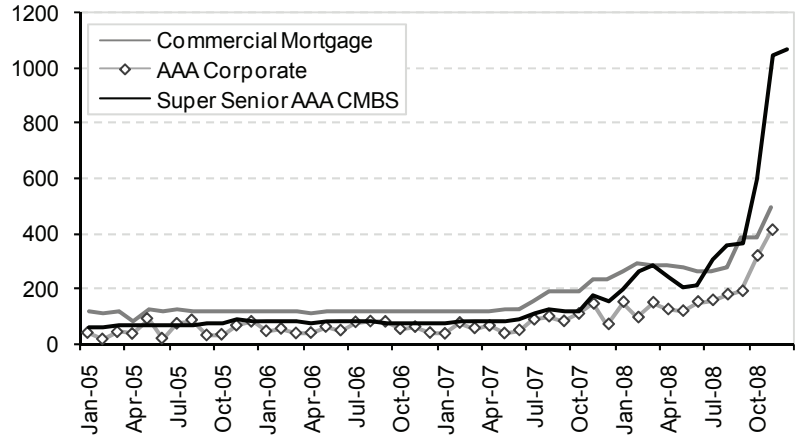
## Debt Markets – Lenders Remain Cautious

By the end of 2008, debt was hard to come by, no matter how solid the sponsor or the property. The CMBS market is the most obvious and most dramatic example of the withdrawal of credit from the commercial property sector. But life companies and commercial banks also reduced volume and some stopped lending entirely. Notwithstanding the massive infusions of capital into the banking system through the TARP program, the banking community has remained preoccupied with survival, which has meant, by and large, preserving capital to shore up balance sheets. They have shown no proclivity to resume real estate lending in any meaningful way. To the extent financings are getting done, they are often simply extensions of existing loans that have come due. In most cases, neither borrower nor lender has much choice other than to buy time and hope for a better day.

**Debt Capital More Expensive Across the Board**

**Spreads of Commercial Mortgages and Triple-A CMBS and Corporate Bonds**




Morgan Stanley, Prudential Mortgage Capital

The biggest sources of debt – commercial banks, CMBS, life companies and the quasi-federal agencies – all have problems. CMBS is the most glaring example. It is difficult to see how securitization programs will rebound enough to lend at all in 2009. The blow-out of CMBS spreads has made the product untenable. The most-senior triple-A CMBS class ended the year trading nearly 1000 bps over 10-year Treasuries, and that represented a rally from a high point of 1400 bps in mid-November. Triple-B bonds were priced to yield about 3500 bps, down from the November high point of an unfathomable 8000 bps. It is impossible for CMBS programs to write loans with their cost of capital that high. What's more, the vast majority of securitization teams have been dismantled, and the few that remain have been reduced to skeleton crews. When CMBS spreads drop to levels that would be conducive to lending, banks are willing to accept the risk inherent in the business, and the industry develops a structure that will be amenable to fixed-income investors, it will take additional months to rev up securitization machines. As a result, CMBS programs, which originated more than $250 billion of product in the U.S. in 2007, will be hard-pressed to write any loans in 2009.

The global credit crunch will limit the activity of commercial banks and life companies. Skittish banks are lending less in all sectors to conserve capital for their own balance sheets. Certainly, at some point, business units dedicated to lending have to operate normally if they are to generate profits. But it is likely

that the cautious tone will prevail through the first few months of the year as institutions wait to assess economic conditions, the impact of the $700 billion TARP program and the additional $750 billion-plus stimulus package promised by the incoming Obama administration. If the government's efforts have a positive impact relatively quickly, then lenders should come back to the commercial real estate market sooner rather than later. On the other hand, if the recession deepens, many lenders will remain sidelined for a longer period of time.

The only sources of debt that remain consistently available are Fannie Mae and Freddie Mac, which essentially have become part of the federal government. Still, considerable uncertainty surrounds the future of the multi-family lenders, and whether they will be required to shrink their balance sheets. Their fate probably will be subject to the policy of the Obama administration, which is not clear at this point.

The other half of the debt equation hinges on tighter underwriting standards. Lenders have stopped the fast and loose underwriting practices that were prevalent in recent years. Loans will carry lower leverage and will be more expensive for borrowers. These dynamics will make it more difficult to complete property sales without assumable financing or seller financing. Market conditions dictate general inactivity. Few owners who bought when cap rates were low in recent years are likely to sell now, unless there is distress.

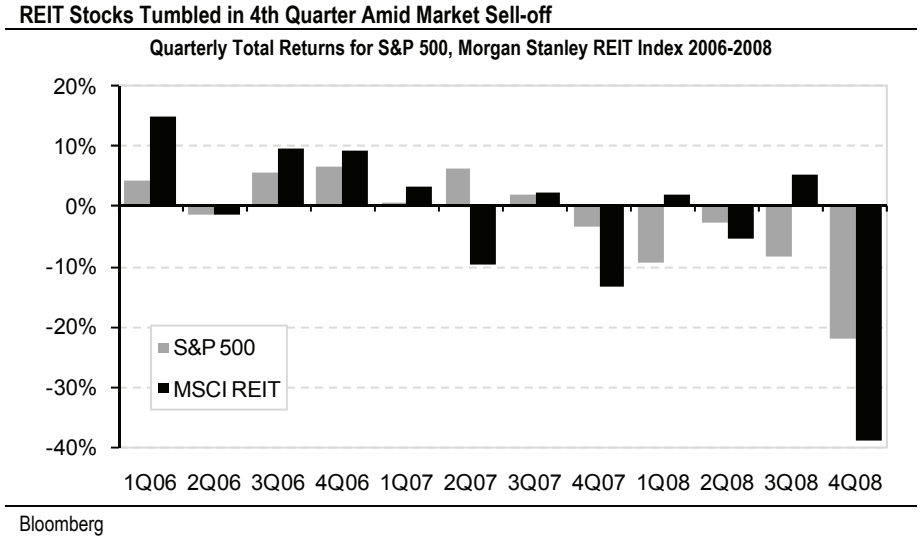
How the market copes with the short supply of debt will be a key variable in 2009 and beyond. Some $300 billion to $350 billion of commercial mortgages are set to mature annually over the next couple of years, which creates a dilemma for borrowers who own large properties or need to replace loans with more than moderate leverage. Some will be forced to put more equity into assets. Others may default and create a spate of distressed sales, although banks are likely to extend many loans to avoid foreclosures.

**REIT Market – Volatility Clouds the Picture**

The REIT equity market suffered through its worst year ever in 2008. The Morgan Stanley REIT index dropped 38% during the year, and that marked a recovery of sorts after being down more than 50% at some points in the fourth quarter. The sector was wracked not only by the general decline in the equity markets, but by REITs' association with financial companies and concerns about liquidity. The pricing of REIT stocks is heavily dependent on balance sheet issues. Companies with significant near-term refinancing volume were hard-hit due to concerns that they will have trouble replacing debt that is rolling over. Not only will it be a problem to find banks willing to provide copious amounts of debt, but any debt originated in 2009 is likely to have a much higher coupon than the debt it is replacing. Higher-cost debt for REITs could create cash-flow issues or increase the possibility of technical defaults, such as violating the debt-service covenants of long-term debt that is not maturing.

For REITs, 2009 will be a good opportunity to hunker down and get balance sheets in order to get into position to prosper when the economy picks up and equity markets rebound. In other words, the goal will be to survive rather than thrive. When the downturn ends, be it late 2009 or sometime next year, REITs with strong balance sheets will be in a good position relative to private equity capital to capitalize on the market's distress. It is difficult to see a scenario over the short term in which large amounts of capital for core real estate investments will flow to private entities. Many institutional investors are struggling with the denominator effect and won't commit new capital to commercial real estate until portfolio allocations are more in line with target levels. REITs that emerge with strong balance sheets will be among the more

attractive real estate investment vehicles through which to take advantage of the market recovery. On the other hand, REITs that levered themselves aggressively may be candidates to be taken over or restructured during the year.




The bull in the REIT china shop is volatility. The 23 worst days in the Morgan Stanley REIT Index's 13-year history all took place in 2008, all but two of those between September and December. Similarly, all of the index's 25 most-positive days occurred during the year, with most of those in the fourth quarter. The wild swings were reflected in the NAREIT US Real Estate Index, which declined 32% in October and 23% in November before rising 18% in December. Volatility was prompted by reactions over negative news about individual REITs, the overall skittishness of the market and indiscriminate selling as investors retreated from virtually all risky assets. It also reflects an influx of short-term trading via exchange-traded funds and macro investors who are betting on sectors rather than individual firms. The volatility is a reflection of the extraordinarily unusual circumstances in which the financial markets are mired and likely to abate as the uncertainty ebbs. However, if excessive volatility continues, it could reduce investor confidence in the sector. REITs were long considered a haven from volatility because their income is derived from long-term leases.

In tandem with the drop in equity prices, REIT dividends rose to an attractive level, although they are subject to be cut or reconstituted as common stock. NAREIT's average dividend for an equity REIT on Jan. 3 was 7.8%, up from 7.6% a year ago, 4.9% in January 2007 and 3.7% in January 2006. At year-end 2008, REITs were priced at a level that implies an 8.3% cap rate for their property portfolios, according to Citigroup. It is hard to say whether that represents market value, as property cap rates are in the process of rising from historical lows and where they stop is not yet clear. REITs also will be impacted by the poor economy, but how much is open to question. REIT operating fundamentals weakened in 2008, and will likely worsen in 2009, although much of that is already factored into share prices. Overall occupancy of REIT properties dropped to 93% at 3Q08, down from the 4Q07 peak of 94.3%, according to Citigroup. The decline is expected to continue in 2009, but the numbers are relatively high by historical levels.

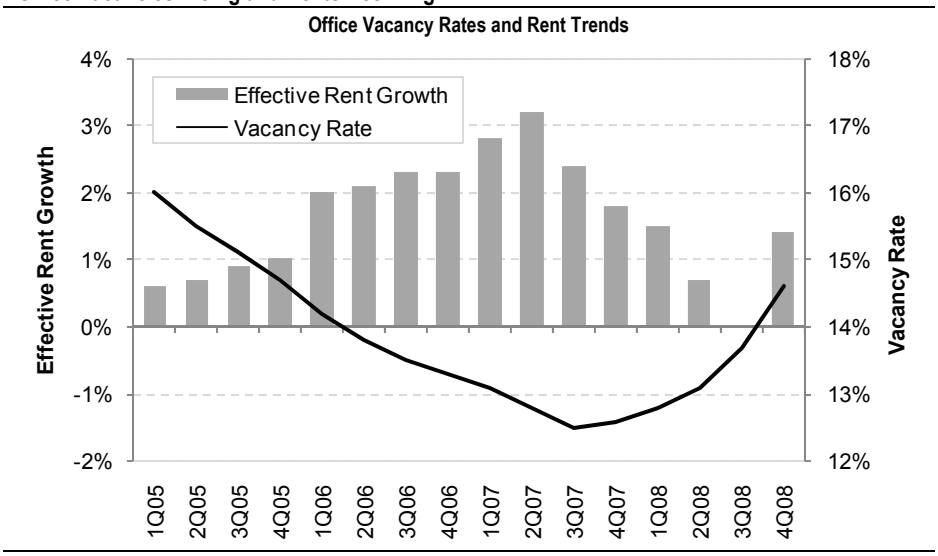
Estimating a return for REIT equities in an environment with such pronounced volatility is difficult at best. On some days in 2008, the sector's market value changed – both up and down – more than it has moved

over the course of entire years. Still, after two down years in which negative sentiment has devastated share prices, we see some light at the end of the tunnel. The liquidity and forward-looking nature of the public market should assure that the recovery in REITs will lead any rebound in the private market, creating attractive opportunities for well-capitalized REITs and their investors. Although heightened volatility makes it difficult to predict the magnitude of the rebound, we would not be surprised to see REIT equity prices advance by 20-30% in 2009, provided the debt markets stabilize.

**Property Markets – More Bad News on the Horizon**

As the year begins, property fundamentals seem to be eroding across the board. Pain is not focused on – or limited to – particular sectors or regions. The overleveraging that is at the heart of the downturn had taken root in individuals and corporations alike, and all are suffering from its effects.

**Office Vacancies Rising and Rents Declining**



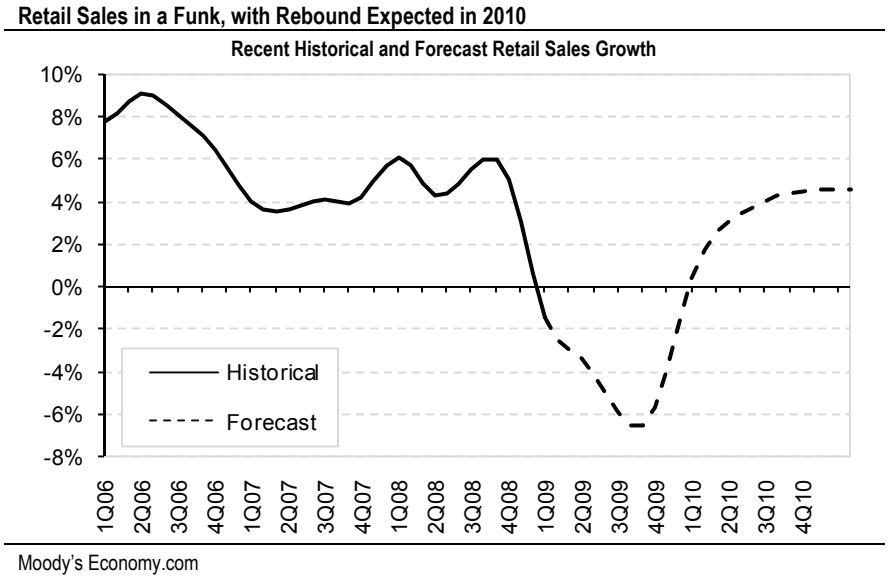

Reis

*Office:* The outlook is dour after almost 2 million jobs were lost between September and December, bringing the yearly total to 2.6 million. Moody's Economy.com is predicting the U.S. will lose 4.4 million total jobs before the cycle is over. The U.S. unemployment rate rose to 7.2% at year-end, its highest peak since January 1993, according to the Labor Department. The rate is likely to climb to 9% by the end of the year, the highest it has been since the early 1980s. According to Reis, the national office vacancy rate rose to 14.4% at yearend, up from 13.7% at the end of September. Negative net absorption was nearly 20 million square feet for the quarter and 42 million sf for the year, the largest one-year decline since 2001. Rents slipped 1.2% in the quarter, the first negative number since 1Q04. The slowdown is broad-based, with office vacancies rising in 71 of the 79 markets tracked by Reis.

*Industrial/warehouse:* A confluence of events has served to put the industrial sector in its worst position in decades. Rising job losses, falling sales of everything from automobiles to housing goods and weak demand for imports due to the global recession have reduced demand for industrial space. The Institute for Supply Management's factory index, which measures a range of factors that include prices, production and employment, fell to 32.4 on Jan. 2, its lowest level since 1980.

*Hotel:* Business and vacation travel is on the downswing, creating a bleak outlook for the hotel market. According to Smith Travel, the average occupancy rate for all hotels dropped to 51.9% in November, down from 58.1% in November 2007. Revenue per available room (RevPAR) fell 12.9% year-over-year, to $52.86 in November, from $60.68 in November 2007. The performance of all types of hotels declined, but luxury and resort hotels fared the worst. The average occupancy of luxury hotels fell 15%, to 59.2% in November from 69.7% in November 2007. Meanwhile, luxury hotel RevPAR dropped 20.7%, to $165 in November from $208 in November 2007.

*Retail:* With families saving more and tapping home equity lines less, consumer spending is at its weakest level in decades. The International Council of Shopping Centers estimates that retail sales fell by 1.5% to 2% in November and December, the worst performance since the trade group began compiling statistics in 1970. According to Reis, vacancy rates of neighborhood and community shopping centers rose to 8.9% in the fourth quarter, up 50 bps over three months earlier. The 4.1 million sf of space vacated during the quarter brought the national shopping center vacancy rate to its highest level since 1994.




*Multi-family:* The outlook for the apartment sector is buoyed by the fact that Fannie Mae and Freddie Mac have continued to provide a source of debt that is not available for other property types. Still, the rise in unemployment points to weak household formation. According to Reis, the national apartment vacancy rate rose 40 bps in the fourth quarter, to 6.6% at yearend, while effective rents fell 0.4% bps during the quarter. The S&P/Case-Shiller index, which measures house prices in 20 cities, declined 18% in October from a year earlier, the biggest drop in the history of the index. Still, the outlook for apartments remains strong over the long term. The short-term nature of apartment leases allows the sector to recover quickly from a downturn, and the demographics of the echo-boomer generation will facilitate robust growth in demand in upcoming years.

One consolation is the reduction in construction across property types. New construction that has been started will continue in almost all cases, but there is virtually no debt available for any speculative development. Relatively little supply is in the pipeline and there is scant chance that development will

resume quickly once capital and space market conditions improve, which could facilitate a more rapid recovery once the economy regains its footing.

With negative data coming from all sides, including the rise in cap rates, the NCREIF index was poised to post its worst drop ever in the fourth quarter. The outlook for 2009 is not much better. We expect further erosion in appreciation in the first half of 2009 before property values stabilize. As a result, the total NCREIF return for 2009 should be in the range of -7% to -12%, with slightly more than 6% income yields offset by a reduction in property values of approximately -13% to -18%.

**Closing Thoughts**

If it was unrealistic at this time last year to hope that the commercial real estate market would experience no more than collateral damage from the subprime residential mortgage fallout, it may be equally mistaken to take this year's pessimism to extremes. Those who study recent cycles know that there is greater potential for outsized returns when prices are low, as they are likely to be for the next year or two. Of course, understanding such a proposition intellectually and being in position to act upon those convictions are two different things. Assets may be cheap, but few have the capital to buy. Institutions are reluctant to sink more money into the sector and borrowing, if it can be done, is expensive. What's more, prices in other asset classes have fallen sharply, which provides competition for opportunistic investment dollars.

In such a climate it is prudent to be cautious, with an eye toward being ready to act when the market comes more into focus. Certainly the market will face consequences over the near term as a result of poor economic fundamentals, but history demonstrates that it is the wrong time for investors to waver on their commitment to the sector. There will be opportunities arising from the hardship of firms that borrowed too much or bought assets at unrealistic prices with unworkable expectations. For those who have the inclination, the expertise and the capital, chances to buy distressed assets are likely to be plentiful.

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